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April 14, 2010

Via Electronic Mail & Online Filing

Jennifer J. Johnson
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Docket No. R-1384

Re: Notice of Proposed Rulemaking: Truth in Lending.
75 Fed. Reg. 12334 (March 15, 2010); Implementing the Credit Card Accountability Responsibility and Disclosure Act (the "CARD Act").

Dear Ms. Johnson:

Pepper Hamilton LLP appreciates this opportunity to comment on the above cited Notice of Proposed Rulemaking (the "Proposal"), proposed by the Federal Reserve Board ("FRB" or the "Board"). Pepper Hamilton LLP is a law firm which represents financial institutions in connection with financial services regulatory concerns. The views expressed herein are based upon our current and prior representation of various types of financial institutions, including credit card issuing banks (collectively, the "Institutions"), as well as upon our own views of the issues that these Institutions will face under the Proposal. While we believe that most of the provisions contained in the Proposal reflect sound consideration on the part of the FRB, and provide clear direction for Institutions on compliance with Regulation Z, there are several points that warrant either revision or clarification.

Of particular concern for the Institutions, as discussed in greater detail below, is proposed § 226.52(b)(2), which effectively places a cap on the penalty fees that a card issuer may impose. The Institutions believe that as currently proposed, this provision is inconsistent with § 102 of the CARD Act in that it eviscerates the specifically stated factors that Congress directed the FRB to consider, that it provides a substantial industry restriction that far exceeds the scope of the CARD Act, and that it will likely result in marked consumer confusion.

Reasonable and Proportionate Fees

Limitations on Fees – Reasonableness of Penalty Fees

The Proposal requires that penalty fees must be reasonable and proportionate. A penalty fee for violating the terms or other requirements of a credit card account under an open-end consumer credit plan must either (i) represent a reasonable proportion of the total costs incurred by the card issuer as a result of the type of violation (i.e., fees based on costs), or (ii) be reasonably necessary to deter the type of violation at issue using an empirically derived, demonstrably and statistically sound model that reasonably estimates the effect of the amount of the fee on the frequency of violation.

Cost-based Fees

Under the cost-based fee approach, a card issuer may impose a charge, other than a charge attributable to a periodic interest rate, for violating the terms of an account if the issuer has determined that the dollar amount of the charge represents a reasonable proportion of the total costs incurred by the issuer as a result of that type of violation.[1] The fees need not be based on costs incurred as a result of a specific violation of the account terms. Instead, a fee must represent a reasonable proportion of the costs incurred by the issuer as a result of that type of violation. The factors relevant to this determination include: (a) the number of violations of a particular type experienced by the issuer during a prior period; (b) the costs incurred by the

[1] Proposed §226.52(b)(1)(i).

issuer during that period as a result of those violations; or (c) the card issuer's reasonable estimate of the number of violations of a certain type and the resulting costs during an upcoming period.[2]

Comment

In the Proposal, the Board has solicited comment on whether card issuers should be permitted to include losses and associated costs as permissible costs in establishing permitted fee levels. The Institutions believe that the final rule should take an inclusive approach to defining the costs associated with a violation, to include all associated costs and losses that may result. Within the range of such costs would naturally exist the losses that card issuers can show are the proximate result of the violation at issue.

The Institutions also believe that the Board should provide greater clarity as to how card issuers may measure permissible costs in connection with establishing the permitted fee levels. The Proposal sets forth guidance with respect to a fee being a reasonable proportion of the total cost incurred by the issuer, however, the Proposal is less clear about which total costs are to be included. The Institutions believe that card issuers should be able to establish a cost baseline by including, for example, the total fixed costs attributable to pursuing delinquent customers or curtailing violative conduct, plus a historical measure of the average variable costs attributed to violative conduct, divided by the average number of violating customers per billing period.

Deterrence-based Fees

Under the deterrence-based approach, a card issuer may impose a fee for violating the terms of an account if the card issuer has determined that the dollar amount of the fee is reasonably necessary to deter that type of violation using an empirically derived, demonstrably and statistically sound model that reasonably estimates the effect of the amount of the fee on the frequency of violations.[3] The Proposal does not require that penalty fees actually deter

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2 Proposed Comment 52(b)(1)(i)-1.

3 Proposed §226.52(b)(1)(ii).

individual consumers from engaging in specific violations. Rather, a fee must be reasonably necessary to deter the type of violation for which the fee is imposed.[4]

Modeling for Deterrence-based Fees

Proposed Comment 52(b)(1)(ii)-2 requires that if a model is used, it must reasonably estimate a statistical correlation between the imposition of a fee and the frequency of a type of violation. In order to support a determination that the dollar amount of a fee is reasonably necessary to deter a particular type of violation, a model must reasonably estimate that, independent of other variables, the imposition of a lower fee amount would result in a substantial increase in the frequency of that type of violation. "The parameterization" of the model must identify a lower fee level above which additional fee increases have no marginal effect on the frequency of violations.

Comment

The Institutions believe that additional guidance as to the modeling structure is warranted. In providing greater clarity, the Board could either offer an official FRB approved model that card issuers may utilize, or provide case-by-case review of individual card issuer models. As an alternative to providing an official FRB-approved model, the Board could provide greater detail as to the elements of an appropriate model.

We further note that a flat-fee approach, wherein consumers are charged a flat fee based on specific conduct regardless of the cost "associated" with the conduct, is already being used elsewhere in the marketplace. For example, in order to deter passengers from switching flights, the airline industry routinely imposes a flat fee to change a flight – in addition to any differential in the cost of the new ticket. Merchants also impose flat NSF fees that are not priced relative to the amount "associated" with the underlying conduct. In short, the value of pricing penalty fees such that they in fact actually deter disfavored conduct has been embraced by other industries. The credit card lending industry should not be an exception. In that regard, we believe that anecdotal evidence derived from consumer behavior in the market and fees based upon card issuers' experience are as compelling as any outcome derived from statistical models, especially when smaller card issuers without comprehensive econometric modeling resources are involved.

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4 Proposed Comment 52(b)(1)(ii)-1.

Limitation on Fees – Prohibited Fees

A card issuer must not impose a fee based on violating the terms of the account that exceeds the dollar amount associated with the violation at the time the fee is imposed.[5] The proposed staff commentary provides several examples of fees that exceed the dollar amount associated with the violation: (a) Late payments: The dollar amount associated with a late payment is the amount of the required minimum periodic payment that was not received on or before the payment due date;[6] (b) Returned-payment fees: The dollar amount associated with a returned payment is the amount of the required minimum periodic payment due during the billing cycle in which the payment is returned to the issuer. If a returned payment has been resubmitted for payment by the issuer, the issuer may not impose a separate fee if the payment is again returned;[7] (c) Over-the-Limit Fees: The dollar amount associated with an over-the-limit transaction is the total amount of credit extended by the issuer in excess of that limit as of the date on which the over-the-limit fee is imposed. Although §226.56(j)(1)(i) prohibits a card issuer from imposing more than one over-the-limit fee per billing cycle, the card issuer may choose the date during the billing cycle on which to impose the fee, subject to certain conditions.[8] A card issuer may not impose more than one penalty fee based on a single event. A safe harbor would permit card issuers to comply with this requirement by imposing no more than one penalty fee during a billing cycle.[9]

Comment

The Institutions see several problems with the implementation of proposed §226.52(b)(2). First, the Proposal fails to appreciate the important corrective role of penalty fees in encouraging customers to comply with the account agreement. For example, even if the card issuer can demonstrate that the proposed returned check fee would have a substantial deterrent effect pursuant to proposed §226.52(b)(1)(ii), the card issuer is nonetheless prohibited from

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5 Proposed §226.52(b)(2)(i)(A).

6 Proposed Comment 52(b)(2)(i)-1.

7 Proposed Comment 52(b)(2)(i)-2.

8 Proposed Comment 52(b)(2)(i)-3.

9 Proposed §52(b)(2)(ii), Proposed Comment 52(b)(2)(ii).

imposing that returned check fee if it would exceed the amount associated with the violation, e.g., the minimum payment amount.[10] The Board should consider establishing some other benchmark against which to label a fee as "prohibited." For example, the final rule could prohibit fees that are in excess of twice the amount of the minimum required monthly payment. Thus, for example, if the minimum payment is $30, and the customer's check is returned for insufficient funds, then a penalty fee capped at $60 would have a strong punitive and deterrent effect on the customer, without creating an unbearable hardship. In order to alleviate regulatory concerns that a penalty fee equal to twice the amount of the required minimum monthly payment has the potential to be disproportional, such fee could be subject to a maximum amount of, for example, $100.[11] Though we do not have empirical data to evaluate the effect of pricing penalty fees at twice the amount of the minimum required monthly payment, we believe that it would fulfill the card issuer's interest in having customers comply with account agreements, would protect the customers' interest in managing his or her account responsibility, and would serve the FRB's interest in preventing penalty fees from becoming an extreme hardship for the customers.

The general prohibition in proposed §226.52(b)(2) would also lead to a card issuer response that, while consistent with the CARD Act, may yield a result unintended by the FRB. Under proposed §226.52(b)(2), a card issuer is free to increase the minimum payment due amount (which appears to be the benchmark for the Proposal's fee limitations), in order to allow the card issuer to charge higher penalty fees. For example, if the card issuer currently calculates the minimum payment due based on 1% of an outstanding balance of $1000, it would result in a minimum monthly payment of, for example, $10, then the maximum late fee amount that may be charged would also be $10.[12] Card issuers may decide to modify the existing formula to require a minimum payment due based on 3% of an outstanding balance of $1,000, thereby increasing the minimum payment due and maximum late fee amounts to, for example, $30. As the Institutions believe that this reaction would be highly likely on the part of card issuers, we ask that the FRB acknowledge that such would not be prohibited by the CARD Act nor the final rule. While it is certainly conceivable that this practice may increase fees, while simultaneously increasing customer delinquency and default, it does not appear to be prohibited by the CARD

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[10] Proposed Comment 52(b)(2)(i)-2(ii).

[11] This suggested rule would apply to all types of violations except for over limit violations, which would instead be treated as contemplated in the Proposal.

[12] *See* example contained at Proposed Commentary 52(b)(2)(i)-1.

Act, and in fact seems to be a likely, albeit unfortunate (in the case of increased delinquencies) result. This practice can be minimized by promulgating a final rule that gives card issuers slightly greater flexibility in setting penalty fees.

The proposed cap on penalty fees will also be problematic because it will cause definite customer confusion due to the variable nature of the penalty fee. For example, the over limit fee, or late payment fee, may change from one month to the next. As a result, the customer will be unable to determine the basis for calculating the fee. Moreover, the card issuer's staff will also incur an added burden of managing and distinguishing the differing fees, particularly when discussing consumer inquiries regarding a specific fee.

Beyond the above specific objections to proposed § 226.52(b)(2), the Institutions have serious concerns about the overall operation of this proposed provision, that proposed § 226.52(b)(2) is overly restrictive, and that it is not in keeping with the spirit (and perhaps the language) of the enabling provision in the CARD Act. Section 102(b) of the CARD Act provides with respect to the Board's responsibility in issuing rules implementing the reasonable fee provisions: "In issuing rules required by this section, the Board shall consider – (1) the cost incurred by the creditor from such omission or violation; (2) the deterrence of such omission or violation by the cardholder; (3) the conduct of the cardholder; and (4) such other factors as the Board may deem necessary." Congress explicitly directed the FRB to use these factors to draft rules for assessing whether a fee is reasonable.

As currently drafted, the Proposal does not provide card issuers with meaningful options for determining a reasonable fee relative to their operations. In fact, the options of pursuing the cost-based or deterrence-based approaches to penalty price determinations are in fact not really options at all because even if a fee is reasonable pursuant to either of these two approaches, the fee will violate Regulation Z if it exceeds the cost associated with the violation as expressed in the fee cap under proposed § 226.52(b)(2). The proposed comment has made this point quite clear in noting that even if a proposed fee complies with the cost-based or deterrence-based factors, it is still unlawful if it exceeds the amount associated with the violation.[13]

Even assuming, arguendo, that the FRB may issue proposed § 226.52(b)(2) under the catch-all authorization to consider "such other factors as the Board may deem necessary or

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13 *See* examples contained at Proposed Comment 52(b)(2)(i).

appropriate," in proposing proposed § 226.52(b)(2), the FRB is offering an agency-created factor that will eviscerate the congressionally-mandated factors. Further, the conjunctive nature of the stated factors that Congress has provided in Sec. 102(b) of the CARD Act strongly suggests that in issuing factors against which to measure the reasonableness of a fee, Congress certainly intended that at a minimum costs and deterrence would be significant and available options for card issuers, in addition to whatever other factors the FRB might offer. Therefore, we urge the Board should not substitute congressionally-specified multiple factors with its own singularly determinative factor.

The impropriety of proposed § 226.52(b)(2) is also reflected in the operation of the safe harbor provision, discussed below.

Safe Harbor

The Proposal provides a safe harbor that presumes compliance with the requirement that penalty fees must reflect the card issuer's actual costs, or must serve as a deterrent to future violations. The safe harbor would apply where the penalties do not exceed either (i) $XX dollar amount, adjusted annually by the Consumer Price Index, or (ii) 5% of the dollar amount associated with the violation, provided that such does not exceed $YY. In either case, the amount charged under the safe harbor must not exceed the maximum limits referenced in proposed § 226.52(b)(2), as described immediately above.[14]

Comment

The Board has solicited comment on the safe harbor approach generally.[15] Given that the safe harbor does not at all times offer the card issuer protection from possible violations of the regulation, its benefit is somewhat illusory. A better safe harbor would offer consistent protection to card issuers who reasonably rely on agency rules derived from industry outcomes related to data modeling for fees based on deterrence, or on projections for cost-based penalties.

Beyond the mechanics of the proposed safe harbor provision, the enabling language in the CARD Act suggests that Congress envisioned a safe harbor provision that would

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14 Proposed §226.52(b)(3); Proposed Comment 52(b)(3)-2.

15 75 Fed. Reg. at 12346-12347.

be stronger than that proposed by the Board. Section 102(b) of the CARD Act provides that the Board may issue rules to provide an amount for any penalty fee or charge described under the Truth-in-Lending Act Sec. 149(a) (general requirement for reasonableness and proportionality) that is presumed to be reasonable and proportional to the omission or violation to which the fee or charge relates. The Board's proposal, however, fails to provide a true safe harbor because regardless of whether a card issuer attempts to comply with the rule through the cost-based approach, the deterrence-based approach, or the safe harbor, the card issuer might still violate the fee cap contained at proposed § 226.52(b)(2).

The Institutions believe that if the cost-based or deterrence-based approaches are functioning properly, there should be not a need for the penalty fee cap in proposed § 226.52(b)(2) to apply. To this end, the Institutions recommend that the Board consider offering greater guidance as to the permissible factors that a card issuer may consider in formulating a cost-based approach, and then offer card issuers options through which to determine whether their penalty fees are reasonable and proportionate.

Re-evaluation of Rate Increases

General Rule

Under the Proposal, if a card issuer, on or after Jan. 1, 2009, increases an annual percentage rate that applies to a card account, based on the credit risk of the consumer, market conditions or other factors, that card issuer must periodically review changes in such factors and, if appropriate, reduce the rate applicable to the account.[16] The general rule applies both to increases in annual percentage rates imposed on a consumer's account based on consumer-specific factors, and to such increases due to factors such as changes in market conditions or the issuer's cost of funds.[17] A card issuer must reevaluate increases if the increased rate is actually imposed on the account. For example, if a card issuer increases a penalty rate that could apply, but the consumer has not triggered the penalty rate, then the requirements of §226.59 do not apply until such increased rate actually applies to a balance on the card account.[18]

16 Proposed §226.59(a)(1).

17 Proposed Comment 59(a)-1.

18 Proposed Comment 59(a)-2.

Timing of Rate Reduction

If a card issuer is required to reduce the rate applicable to an account pursuant to proposed § 226.59(a)(1), the rate must be reduced not later than 30 days after completion of the reevaluation.[19]

Comment

The Board has solicited comment on whether a different timing standard for how promptly rate changes must be implemented should apply.[20] The Institutions believe that providing only 30 days in which to reduce interest rates after re-evaluation of applicable factors would be burdensome for card issuers, and could result in needless technical violations. The Institutions request that the FRB provide greater clarity as to the Board's rationale for setting the rate reduction timing at 30 days under proposed § 226.59(a)(2), when the notice period for interest rate increases is 45 days pursuant to existing 12 C.F.R. § 226.9. Generally, card issuers would expect fairness in the adjustment scheme to be reflected by providing the same timing for increases and decreases of the interest rate. In this case, such fairness would warrant allowing card issuers 45 days to decrease an interest rate pursuant to proposed § 226.59(a) re-evaluation, instead of 30 days.

Development and Review of Rate Increase Factors

As discussed above, the Proposal provides that when a card issuer increases an interest rate based on the credit risk of the consumer, market conditions, or other factors, the card issuer must evaluate the application of such factors every six months, and based on such review reduce the interest rate if the conditions have changed.[21] However, the obligation to review the factors and make appropriate adjustments to the interest rate will cease to apply if the card issuer

19 Proposed §226.59(a)(2).

20 75 Fed. Reg. at 12348.

21 Proposed 12 C.F.R. § 226.59(a) and (b).

reduces the interest rate to an amount equal to or less than the amount of the rate prior to the increase.[22]

Comment

The Board has solicited comment on whether more guidance is necessary regarding whether a card issuer's policies and procedures are "reasonable."[23] As a preliminary matter, we urge the Board to confirm in the staff commentary to the final rule that if the policies and procedures developed by a card issuer are themselves "reasonable," then the outcomes of applying such policies and procedures are also reasonable. Put another way, we ask that the Board confirm that regulators should not second-guess – or attempt to overrule – the outcome of properly applied policies and procedures. Assuming that the Board agrees that the focus of supervisory examinations should be on the reasonableness of the policies and procedures rather than on outcome-based results, we request that the Board provide greater guidance on the Board's expectations so as to ensure that such policies and procedures will comport with examiners' expectations, and that those examiner expectations will be applied consistently across all card issuers.

The Board has solicited comment on the operational issues associated with reducing the rate applicable to a consumer's account.[24] The Institutions believe that chief among the operational issues associated with proposed § 59 is the application of the factors to be considered when increasing or decreasing a customer's account. The proposed rule provides that a card issuer may increase an annual percentage rate "based on the credit risk of the consumer, market conditions, or other factors."[25] The Institutions believe that this provision requires clarification in several respects. First, we ask that the Board clarify that if a card issuer increases an interest rate based on several factors being triggered, the fact that one of those factors may have changed in the customer's favor upon the 6 month review, does not necessarily mean that the card issuer must decrease the interest rate to the previous position. For example, assume that a card issuer's policies and procedures identify consumer credit risk and market conditions as the

[22] Proposed 12 C.F.R. § 226.59(f).

[23] 75 Fed. Reg. at 12349.

[24] 75 Fed. Reg. at 12348.

[25] Proposed § 226.59(a)(1).

two factors to be consider in increasing the interest rate. If the interest rate is increased from 15% to 20% based on negative indicators of consumer credit risk on January 1, 2011, and upon review of the application of the factors on June 30, 2011, the review shows that the negative consumer credit risk indicators have been resolved but that market conditions have worsened, then it would appear from the proposal that the card issuer could sustain the increased interest rate based on its consideration of the worsened market conditions as reviewed under the card issuer's reasonable policies and procedures. This view would appear to be supported by the language of the Proposal, which provides that upon its review, "[t]he card issuer may, at its option, review the factors on which the rate increase was originally based, *or may review the factors that it currently considers* when determining the annual percentage rates applicable to its credit cards accounts."[26]

Second, also considering the above hypothetical, we ask that the Board confirm that in the event that the card issuer increases the interest rate based on customer credit risk and market conditions, and the customer credit risk has been entirely resolved, but the market conditions have not improved, then the card issuer may still sustain the increased interest rate. This would also appear to be permissible under the Proposal.

Third, we ask that the Board clarify to what extent examiners will determine the validity of an individual factor. For example, a card issuer could formulate policies and procedures that consider the card issuer's earnings sustainability as a legitimate and appropriate basis to vary the interest rate on a credit card account. We ask the Board to either confirm that earnings sustainability is an acceptable factor, or confirm that the CARD Act and the final rule do not permit the agencies the discretion to determine whether or not a factor selected by the card issuer is appropriate.

The Board has solicited comment on whether the obligation to review the rate applicable to a consumer's account should terminate after some specific time period following the initial increase.[27] Though the Proposal offers 5 years as an example, we believe that 3 years

[26] Proposed 12 C.F.R. § 226.59(d) (emphasis added). This view is also supported by proposed Staff Comment 59(b)(1), 75 Fed. Reg. at 12374, which provides that if the customer's rate is increased due to, for example, a late payment, and the customer makes all required payments on time for 6 months following the rate increase, then the card issuer is not required to return the rate to that applied prior to the increase, if such failure to reduce is consistent with the card issuer's reasonable policies and procedures.

[27] 75 Fed. Reg. at 12352.

is a more appropriate time period because it would allow sufficient time for the customer to obtain the benefit of having the interest rate subject to periodic re-evaluation, but would also limit the administrative burden on card issuers of having to engage in a potentially indefinite review process.

Conclusion

As discussed above, while the Institutions share the Board's goal of promoting greater accountability and responsibility in open-end consumer lending, there are certain points in the Proposal where additional clarification of the regulation's provisions and the Board's expectations is warranted.

Should you have any questions regarding the discussion above, please do not hesitate to contact me at (202) 220-1210, or my colleague, Travis P. Nelson, at (215) 981-4187.

Sincerely,

Timothy R. McTaggart

Timothy R. McTaggart